INTRODUCTION

Mortgage lending provides funds for the acquisition or holding of residential and commercial real estate and has long been a traditional activity of the thrift industry. Loans are generally long-term in nature and are secured by the real property. Institutions engage in real estate mortgage lending to promote home ownership and to foster economic development in their market area, thereby providing a source of low-risk investment for the institution. In addition, institutions are increasingly looking to the origination and sale of mortgage loans in the secondary market as an alternative to portfolio lending in order to reduce the interest-rate risk associated with funding long-term assets with short-term liabilities and to generate fee income from servicing loans that have been sold. These activities represent unique risks and are addressed in the Mortgage Banking sections of the Thrift Activities Regulatory Handbook.

Types of Real Estate Lending

Historically, savings associations have concentrated their lending activities on the financing of residential real estate, typically single-family residences, and multifamily apartment units. More recently, associations have become active in a wider range of real estate lending, including the financing of commercial and other nonresidential real estate.

Residential mortgage lending typically involves the construction, purchase, or refinancing of single-family or multifamily real estate. Commercial real estate lending, often referred to as income property lending, typically involves the construction, purchase or refinancing of commercial retail, industrial, and other nonresidential properties to be used in a business operation or held for investment. Because multifamily residential properties are operated as businesses, they are also considered by some to be commercial real estate.

This Handbook Section discusses the general characteristics and risks involved in the permanent financing of residential and income property real estate. Construction lending is more fully discussed in Handbook Section 213.

Real Estate Lending Standards Rule

In an effort to curtail abusive real estate lending practices and reduce risks to the depository insurance funds and enhance the safety and soundness of insured depository institutions, Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991. Section 304 of the Act requires each federal banking agency (the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision [the agencies]) to adopt uniform regulations prescribing standards for extensions of credit secured by liens on or interests in real estate or made for the purpose of financing the construction of a building or other improvements to real estate, regardless of whether a lien has been taken on the property.

In establishing these standards, the agencies had to consider: (1) the risk posed to the depository insurance fund by such extensions of credit; (2) the need for safe and sound operation of depository institutions; and (3) the availability of credit.

On December 31, 1992, the agencies adopted a final rule prescribing real estate lending standards that requires each insured depository institution to adopt and maintain written internal real estate lending policies that are consistent with safe and sound banking practices and appropriate to the size of the institution and the nature and scope of its operations.

The policies must establish:

- Loan portfolio diversification standards;

- Prudent underwriting standards, including loan-to-value (LTV) ratio limits that are clear and measurable;
- Loan administration procedures for the institution's real estate portfolio; and
- Documentation, approval, and reporting requirements to monitor compliance with the institution's real estate lending practices.

The institution's written real estate lending policies must be reviewed and approved by the institution's board of directors at least annually. Further, each institution is expected to monitor conditions in its real estate market to ensure that its lending policies continue to be appropriate for current market conditions. Finally, the rule establishes that the lending policies established by the institution should reflect consideration of the Interagency Guidelines for Real Estate Lending Policies adopted by the agencies in conjunction with the final rule.

The final Real Estate Lending Standards rules of the four banking agencies were published in the Federal Register on December 31, 1992 and became effective on March 19, 1993. The rule applicable to savings associations, together with the Interagency Guidelines, are contained in 12 CFR 563.100-101. Also, several regulations under 12 CFR 545.32, that established regulatory LTV ratio and term limitations, were amended or rescinded with the issuance of the new rule. Such limits will now be established by each association's board of directors and should be embodied in its real estate lending policies.

During examinations, regulators should determine if associations have adopted adequate written internal real estate lending policies in conformity with 12 CFR 563.100-101 and that their lending staff are adhering to those policies. It should be noted that the underwriting guidelines and LTV ratio limitations established by the Interagency Guidelines are guidelines, not absolute requirements.

The interagency real estate lending guidelines discuss the need for each institution to have comprehensive and consistent lending policies that have been approved by the board of directors. The guidelines cover several important aspects of lending policies: (1) loan portfolio management, (2) underwriting standards, (3) loan administration, (4) supervisory LTV ratio limits, and (5) the treatment of loans in excess of the supervisory LTV limits and exceptions to the general lending policy.

"Loan Portfolio Management" stresses the need for an institution's real estate lending policies to contain an outline of the scope and distribution of the institution's credit facilities and the manner in which real estate loans are made, serviced and collected, and lists several particular items that should be addressed.

"Underwriting Standards" lists several relevant factors that prudent underwriting should address, such as the capacity of the borrower, or income from the property to service the debt, and the overall creditworthiness of the borrower.

"Loan Administration" lists loan administration procedures that the institution's loan policies should address, such as documentation standards, collateral administration, and loan extensions and modification.

"Supervisory Loan-to-Value Limits" states that institutions should establish their own individual LTV ratio limits that should not exceed the following supervisory limits:

Loan Category	Percent
Raw land	65
Land development	75
Construction:	
Commercial, multifamily,(1) and other nonresidential	80
Improved Property	85
Owner-occupied one- to four-family and home equity	(2)

(1) Multifamily construction includes condominiums and cooperatives.

(2) A loan-to-value limit has not been established for permanent mortgage loans on owner-occupied, one- to four-family residential property. However, for any such loan with a loan-to-value ratio that

equals or exceeds 90% at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

"Loans in Excess of the Supervisory Loan-to-Value Limits" discusses when loans in excess of the supervisory LTV limits may be appropriate and establishes guidelines to limit such loans based on the institution's capital.

Regarding the supervisory LTV ratio limitations, for example, an association may determine that it is appropriate to make certain loans in excess of the supervisory limits. These loans will not automatically be subject to criticism, however, as long as the loans have other credit strengths that outweigh the additional risks inherent in the granting of a loan with minimal borrower equity. Conversely, some loans with LTV ratios at or below the supervisory LTV ratio limits may be subject to criticism for other reasons, such as a loan to a borrower with an unstable financial position, or a loan on a property with inadequate debt service coverage (when the repayment of the loan is dependent on income from the security property), or loans with other unacceptable risks. In essence, associations cannot ignore the higher risks presented with high LTV loans and they cannot over emphasize LTV ratios. They must take into consideration all credit factors when underwriting a real estate loan.

See Appendix A to this Section for answers to the many commonly asked questions about the Real Estate Lending Standards and Guidelines.

Income-Producing Property Lending

There are many types of income-producing properties, including commercial retail and industrial properties, churches, hotels, and multifamily residential properties. Each of these assets present different qualities and risks for a lender. In general, commercial real estate loans have a shorter term than residential real estate loans and, consequently, carry less interest-rate risk than fixed-rate, single-family mortgage loans. According to Office of Thrift Supervision (OTS) net charge-off data, however, nonresidential real estate loans experienced approximately six times the level of net charge-offs as one- to four-family mortgage loans in 1992, and multifamily residential mortgage loans experienced approximately three times the net charge-offs of one- to four-family mortgage loans. Savings associations should be aware of the additional risks of commercial real estate lending.

Nevertheless, commercial real estate lending is necessary for the economic health and development of our communities. If commercial real estate loans are prudently underwritten and the lender properly manages the risks, such loans can be both safe and profitable.

On November 7, 1991, the agencies issued general guidelines on commercial real estate lending. Included in the issuance were discussions of the evaluation and classification of problem commercial real estate loans. The policy statement emphasizes that the evaluation of real estate loans is not based solely on the value of the collateral, but on a review of the borrower's willingness and capacity to repay and on the income-producing capacity of the properties.

The policy statement also provides guidance on how regulatory personnel should analyze the value of collateral. In general, regulators should consider the institution's appraisals of collateral (or internal evaluations, when applicable) to determine value and review the major facts, assumptions, and approaches used in determining the value of the collateral. Regulators need to avoid challenges to underlying assumptions that differ in only a limited way from assumptions that would normally be used for the property under review. Nonetheless, when reviewing the value of the collateral and any related management adjustments, regulators should ascertain that the value is based on assumptions that are both prudent and realistic, and not on overly optimistic or overly pessimistic assumptions.

The policy statement covers a wide range of specific topics, including:

- The general principles that regulators should follow in reviewing commercial real estate loan portfolios;
- The indicators of troubled real estate markets, projects, and related indebtedness;

- The factors regulators should consider in their review of individual loans, including the use of appraisals and the determination of collateral value;
- A discussion of approaches to valuing real estate, especially in troubled markets;
- The classification guidelines followed by the agencies, including the treatment of guarantees; and
- The factors considered in the evaluation of an institution's allowance for loan and lease losses.

The policy statement is intended to ensure that all supervisory personnel, lending institutions, and other interested parties have a clear understanding of the agencies' policies regarding commercial real estate lending. Regulators should review the policy statement before commencing an examination of an institution with a significant level of commercial real estate loans.

Regulatory Review of Commercial Real Estate Loans

Loan Policy and Administration Review

As part of the analysis of an institution's commercial real estate loan portfolio, regulators should review lending policies, loan administration procedures, and credit risk control procedures. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation are essential to the institution's management of the lending function.

The policies governing an association's real estate lending activities must include prudent underwriting standards that are periodically reviewed by the board of directors and clearly communicated to the institution's management and lending staff. The association must also have credit risk control procedures that include, for example, prudent internal limits on exposure, an effective credit review and classification process, and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. The complexity and scope of these policies and procedures should be appropriate to the size of the institution and the nature of the association's activities, and should be consistent with prudent banking practices and relevant regulatory requirements.

Indicators of Troubled Real Estate Markets and Projects, and Related Indebtedness.

In order to evaluate the collectibility of an institution's commercial real estate loan portfolio, regulators should be alert for indicators of weakness in the real estate markets served by the institution. They should also be alert for indicators of actual or potential problems in the individual commercial real estate projects or transactions financed by the institution.

Available indicators, such as permits for, and the value of, new construction, absorption rates, employment trends, and vacancy rates, are useful in evaluating the condition of commercial real estate markets. Weaknesses disclosed by these types of statistics may indicate that a real estate market is experiencing difficulties that may result in cash flow problems for individual real estate projects, declining real estate values, and ultimately, in troubled commercial real estate loans.

Indicators of potential or actual difficulties in commercial real estate projects may include:

- An excess of similar projects under construction.
- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.

- Concessions on finishing tenant space, moving expenses, and lease buy-outs.
- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- Delinquent lease payments from major tenants.
- Land values that assume future rezoning.
- Tax arrearages.

As the problems associated with a commercial real estate project become more pronounced, problems with the related indebtedness may also rise. Such problems include diminished cash flow to service the debt and delinquent interest and principal payments.

While some commercial real estate loans become troubled because of a general downturn in the market, others become troubled because they were originated on an unsound basis. Common examples of these types of problems include:

- Loans with no or minimal borrower equity.
- Loans on speculative undeveloped property where the borrowers' only source of repayment is the sale of the property.
- Loans based on loan values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value.
- Additional advances to service an existing loan that lacks credible support for full repayment from reliable sources.
- Loans to borrowers with no development plans or noncurrent development plans.
- Loans on special use properties for which there is little or no demand.
- Loans made with inadequate regard for the debt load and paying capacity of the borrower.
- Unsound loans to affiliated persons or their interests.
- Renewals, extensions, and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule.

Regulator Review of Individual Loans, Including the Analysis of Collateral Value.

The focus of an examiner's review of a commercial real estate loan, including binding commitments, is the ability of the loan to be repaid. The principal factors that bear on this analysis are the income-producing potential of the underlying collateral and the borrower's willingness and capacity to repay under the existing loan terms from the borrower's other resources, if necessary. In evaluating the overall risk associated with a commercial real estate loan, regulators should consider a number of factors, including the character, overall financial condition and resources, and payment record of the borrower; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral. However, as other sources of repayment for a troubled commercial real estate loan become inadequate over time, the importance of the collateral value in the analysis of the loan necessarily increases.

The appraisal regulations of the federal bank and thrift regulatory agencies require institutions to obtain appraisals when certain criteria are met. Management is responsible for reviewing each appraisal's assumptions and conclusions for reasonableness. Appraisal assumptions should not be based solely on current market conditions that ignore the stabilized income-producing capacity of the property. Management should adjust any assumptions used by an appraiser in determining value that are overly optimistic or pessimistic.

A regulator should analyze the collateral value as determined by the institution's most recent appraisals (or internal evaluation, as applicable). A regulator reviews the major facts, assumptions, and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). Under the circumstances described below, the regulator may make adjustments to this assessment of value. This review and any resulting adjustments to value are solely for purposes of a regulator's analysis and classification of a credit and do not involve actual adjustments to an appraisal.

A discounted cash flow analysis is an appropriate method for estimating the value of income-producing real estate collateral. This analysis should not be based solely on the current performance of the collateral or similar properties; rather, it should take into account, on a discounted basis, the ability of the real estate to generate income over time based upon reasonable and supportable assumptions.

Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward for actual current market conditions.

The real estate appraisal regulation of the federal bank and thrift regulatory agencies include a requirement that an appraisal: (1) follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value; (2) reconcile these approaches; and (3) explain the elimination of each approach not used. A discounted cash flow analysis is recognized as a valuation method for the income approach.

When reviewing the reasonableness of the facts and assumptions associated with the value of the collateral, regulators should evaluate:

- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Volume and trends in past due leases;
- Effective rental rates or sale prices (taking into account all concessions);
- Net operating income of the property as compared with budget projections; and
- Discount rates and direct capitalization ("cap") rates.

The capacity of a property to generate cash flow to service a loan is evaluated based upon rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy and rental rates should be based upon an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate. The analysis of collateral values should not be based upon a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions. Judgment is involved in determining the time that it will take for a property to achieve stabilized occupancy and rental rates.

Regulators should not make adjustments to appraisal assumptions for credit analysis purposes based on worst-case scenarios that are unlikely to occur. For example, a regulator should not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today's market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

When estimating the value of incoming-producing real estate, discount rates and "cap" rates should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions. Exaggerated, imprudent, or unsustainably high or low discount rates, "cap" rates, and income projections should not be used. Direct capitalization of nonstabilized income flows should also not be used.

Assumptions, when recently made by qualified appraisers (and, as appropriate, by institution management) and when consistent with the discussion above, should be given a reasonable amount of deference. Regulators should not challenge the underlying assumptions, including discount rates and "cap" rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. The estimated value of the underlying collateral may be adjusted for credit analysis purposes when the regulator can establish that any underlying facts or assumptions are inappropriate and can support alternative assumptions.

It is also important to recognize that commercial properties represent a wide variety of unique and specialized uses that may represent increased risk to the lending institution, particularly if the institution is forced to look to the sale of the property to satisfy the debt. The holding costs associated with the extended marketing time to sell specialized property, the cost to convert the property to wider uses with greater market demand, and a selling value that may or may not be the same as its appraised value are all unique risks associated with lending on highly specialized properties.

As a result of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), loans on the security of liens on nonresidential real property are subject to limitations of 400% of a federal association's capital. This limitation also applies to state-chartered associations. This change in the limitation does not require the divestiture of any loan that was lawful when made.

One- to Four-Family Residential Lending

Among the safest loans in an association's portfolio are loans to individuals secured by their personal residences. As stated earlier in this section, loan loss rates for one- to four-family permanent loans are much lower than the loss rates for any other loans. Such loans often present less credit risk than commercial and multifamily real estate loans because the risk of default is spread over many small loans rather than a few large loans and because most institutions use standard underwriting criteria for such loans.

Single-family mortgage loans do entail risks - interest-rate risk, default risk, and the risk that properties in a community may experience price declines. These risks can be managed, however, through the establishment and adherence to sound underwriting procedures.

Just as for commercial real estate lending, savings associations must ensure that the borrower maintains sufficient equity in the property and has stabilized and sufficient income to make payments. Also, associations should have established procedures to verify borrower provided information (such as sending out verification of deposit [VOD] letters and verification of income [VOI] letters).

The adoption by the board of directors and implementation by management of a sound real estate loan policy is the best means by which an institution can build and maintain a sound mortgage loan portfolio. If properly formulated, communicated to all lending personnel, and monitored, it serves to guide, direct, and control the decisions of lending officers consistent with the directorate's responsibility and objective of granting loans on a sound and collectible basis. Because each institution is unique, there is no single policy that can best serve all institutions; rather, each institution needs to tailor its policy and procedures to its own specific needs and characteristics. Nevertheless, there are common elements that are found in sound lending policies. These are discussed in Thrift Activities Regulatory Handbook Section 210, Lending Risk Assessment.

It should be noted that the Chief Counsel previously opined that two particular types of securities upon which federal associations may lend include the security of a first lien on a leasehold estate of qualifying term, where such estate is limited to a leasehold interest in an apartment, and secondly, loans secured by a mobile home park.

An institution's real estate lending policy and procedures should include an appraisal program. (For a discussion of appraisal requirements, refer to Thrift Activities Regulatory Handbook, Section 208, Real Estate Appraisal.)

It is important that an institution's real estate loan policy and procedures be augmented by a strong system of internal controls. These controls should emphasize segregation of duties, where appropriate, and provide for the timely receipt, review (both initially and ongoing, as needed), and follow-up of all necessary mortgage loan documentation. Additionally, in order to monitor the credit quality of the portfolio and the loan officer's compliance to or conformity with loan policy and procedures, a system of internal loan review should be implemented. The objectives and elements that compose effective internal loan review systems are contained in the Thrift Activities Regulatory Handbook Section 210, Lending Risk Assessment.

The degree of risk inherent in a real estate mortgage loan depends on the borrower's ability and willingness to repay the loan, the loan amount in relation to the present and future value of the real property over the anticipated life of the loan, and the rate of interest. The institution's real estate loan policy should ensure that loans are granted based on the borrower's ability to properly service the debt.

There have been instances when institutions have made real estate loans based on the purchase price of real estate where the purchase price has included settlement and loan closing charges. While this practice is not inherently unsafe or unsound, it does have potential risks. There could be cause for concern if there are large discrepancies between the appraised value and the purchase price of the property.

Institutions have also made real estate loans based on the purchase price of a condominium or cooperative unit, net of a discount to an existing tenant. This discount is applied as a credit toward the down payment to assist tenants who may otherwise be displaced as a result of a condominium or cooperative conversion. This benefits both the tenant who is unable to make the required down payment and the developer who wishes to avoid displacing tenants.

Artificially inflating the cost of a condominium or cooperative unit so that an amount may be deducted as a discount, however, is not a true discount and is not permissible. Regulators should, therefore, carefully review records on this type of loan to ensure that the loan is not based on an inflated appraisal.

Adjustable-Rate Mortgage Loans

The use of adjustable-rate mortgage (ARM) loans by savings associations can be traced to the early 1980s, when the savings and loan industry was under significant interest-rate pressure. Unlike the conventional fixed-rate mortgage, whose interest rate usually holds constant over the life of the loan, the interest rate associated with an ARM is based on the movement of a predetermined index. The rate is usually set as the function of the predetermined index plus an incremental amount established at the initiation of the loan. This incremental amount is commonly referred to as the gross margin. The combination of the index rate and the gross margin are referred to as the fully indexed rate. Depending on the type of index the ARM is based on, the interest accrual rate can change monthly (11th District Cost Of Funds Index [COFI]) or annually (Constant Maturity Treasury Index [CMTI]). Some ARMs are structured such that there are limits on the amount of the increases and decreases in the interest accrual rate as the result of changes in the underlying rate index. The borrower's monthly payment amount is recalculated at predetermined dates to assure full amortization of the loan over its remaining life at the current fully indexed interest rate. This date is referred to as the payment-adjustment date. Some ARMs are structured such that there are limits on the amount of the increases and decreases in the borrower's monthly payment amount as the result of the required payment adjustment.

Teaser Rates-One feature commonly associated with the ARM product (fixed-rate products also) is the "teaser" or low introductory interest rate. This includes situations where borrowers receive a short-term subsidy or "buy down" of the loan rate from the seller. Teaser rates are used to attract borrowers to do business with the lender (or seller) versus the competition. Teaser rates reduce the initial interest accrual and monthly payment during the period that the teaser is in effect, usually 3 to 12 months. At the expiration of the teaser-rate term, the borrower's monthly interest accrual is calculated at the fully indexed rate, as defined above. Because of the competitive nature of the home mortgage industry, some associations offer borrowers "deep" teaser rates. These rates are significantly lower than the fully indexed rate. Using the deep teaser to qualify a borrower will cause some borrowers to qualify for loans that they would not have qualified for under normal circumstances, under the assumption that their ability to pay will increase with time. The OTS does not support this assumption and is concerned about the potential for increased credit risk, particularly when the LTV ratio exceeds 80%. The qualification of borrowers at below-market rates is considered an unsafe and unsound practice. Associations should generally qualify borrowers at the fully indexed mortgage rate as of the date of commitment. An exception to this policy is when a thrift institution engages in a program of immediately selling such loans, without recourse, to non-thrift third parties, thereby removing the credit risk from its own portfolio.

Interest Rate Buydowns-Similar to the use of teaser or low introductory rates to attract borrowers to conduct business with savings associations, a home builder or some other third party may use a buydown program as an incentive to potential home buyers to purchase their particular property.

In such an arrangement, a home builder or other third party pays the lender at closing a sum sufficient to cover a portion of the interest payments due from the borrower during the initial years of the loan term. Although there is no formal agreement between the home builder and the lender, the arrangement is reflected in a written agreement between the borrower and the lender, whereby the lender agrees to accept from the borrower monthly payments based on the 'bought-down' interest rate for the initial adjustment period of the loan.

OTS regulations place no restrictions on such arrangements. The adjustable mortgage provisions of 12 CFR § 545.33 do not set limitations on periodic and lifetime interest-rate adjustments. Thus, association management has the flexibility to develop buydown programs provided they are underwritten and structured in a safe and sound manner.

Accounting Treatment-Where the buydown payment is in the form of a single, lump sum representing a portion of the interest due during the buydown period, the payment shall be included with other deferred fees and loan costs to determine the net deferred fees for the loan. Such net deferred fees should be amortized over the life of the loan using the interest (level yield) method pursuant to SFAS No. 91.

It should be noted that the accounting requirement described above is not limited to buydown payments on adjustment mortgage loans. Such accounting would be required for any type of loan, whether fixed-rate or adjustable-rate, in connection with which a buydown payment is made.

Appraisals-The existence of a buydown arrangement must be taken into consideration in arriving at an appraisal of the property. If the amount of the buydown is reflected through an increase in the property's sale price to a level higher than on an identical property in the local market on which no buydown is offered, then the appraisal should reflect this fact.

Negative Amortization-One unique feature of some ARMs is the ability for them to negatively amortize. Unlike the conventional fixed-rate mortgage, where the interest accrual rate and annual payment are held constant over the life of the loan, and a portion of each monthly payment reduces the outstanding principal balance of the loan, some ARMs are structured such that the outstanding principal balance can increase, even though the borrower's monthly payments are current. There are two scenarios where this can happen: (1) when, because of increases in the interest accrual rate, the monthly payment is insufficient to cover the interest expense; and (2) when, because of payment-adjustment limitations at the payment-adjustment date, the adjusted payment is insufficient to cover the interest expense at the current interest rate required to amortize the loan balance over the remaining life of the loan.

Pricing of ARMs

The pricing of products and services offered by savings associations must foster a safe and sound thrift industry. Pricing should be competitive and free from collusion by market participants. At a minimum, however, the pricing of mortgage loans should provide sufficient yield to cover the operating expenses, funding costs, and risk premium attendant to the extension of credit. The pricing of mortgage loans at a rate or on terms that do not provide a reasonable expectation of avoiding losses is an unsafe and unsound practice.

Some thrifts may be pricing ARMs improperly as a result of a lack of understanding of the implicit "options" or risks associated with ARMs. There should be a reasonable expectation that "promotional" mortgage loans, such as adjustable mortgage loans that feature "teaser" rates, minimum fees, binding caps, and optional conversion to fixed-rate mortgage loans, will yield a sufficient return over the life of the loan to avoid losses by the insured institution.

With discounted ARMs, institutions quote an initial interest rate and a spread or margin over the index rate to be used in determining subsequent rates. A discount results because the initial rate tends to be significantly lower than the sum of the current value of the index plus the margin. Interest rate change limitations or caps can be yield-depressing. If a cap exists, the loan contract should specify whether it is applicable to the discounted rate or the index plus the margin. If applied to a steeply discounted initial rate, the loan will suffer a large yield concession should the index rate rise during the early years of the loan. If the loan has an overall rate change cap applicable to the initial discounted rate, then it is possible that the lifetime maximum rate would be below the current rate on fixed-rate loans, thereby defeating the purpose of an adjustable-rate mortgage. Caps should not be established in a manner that permanently depresses or allows little flexibility on the yield.

Moreover, interest-rate changes may lead to steep increases in payment burdens and subsequent delinquencies if borrowers are originally qualified at the discounted rate with high payment-to-income ratios. The steeper the rate discount, the larger the periodic rate change cap or the higher the qualifying income ratio, the more likely the possibility of delinquency. It is important that institutions assess a borrower's ability to qualify by measuring current income against projected payments that will result from the interest-rate change. Lenders should also remember to consider the potential for increase in a borrower's income and compare that figure against anticipated higher payments.

In addition to the mispricing of embedded options, institutions should be aware of the repricing risk associated with different indices. The 11th District Cost of Funds is typically a lagging market index. Regulators should also be aware of the use of two distinct one-year maturity Treasury rate series. The institution must specify whether it intends to use, as an index, the Treasury bill rate quoted on a discount basis or on the constant-maturity yield rate. The latter is quoted on a bond-yield basis. Its rate is always higher than the discount rate. The mortgage documents should state precisely which index is used. Advertising and promotional material should in no way imply that the indexes are the same.

The OTS is particularly concerned about insolvent and undercapitalized institutions pricing ARMs without adequately analyzing the potential for losses. Such institutions may be tempted to "grow" out of their problems by making economically unsound loans. Such activity is considered a high-risk strategy, and insolvent and undercapitalized thrifts may not undertake such a strategy. Regulatory Bulletin 3a-1 ("Policy Statement on Growth for Savings Associations") states that the regulatory policy toward insolvent and undercapitalized institutions is one of low or no growth. An exception to this policy may be granted where the regional director (or designee) in order to maintain an insolvent institution's franchise value, approves controlled low-risk growth. Growth through the pricing of products and services without regard to avoiding losses is high-risk, and should not be approved.

Savings associations should carefully price ARMs with a full understanding of the risks associated with these instruments. It is the responsibility of the regional director (or designee) to monitor loan activity by thrifts and to stop such activity when it appears to be an unsafe and unsound practice or is not in the best interest of the insurance fund. Where regional directors (or designees) believe the pricing of ARMs is unsafe and unsound or is not in the best interest of the insurance fund, they should require a pricing analysis by the institution to demonstrate that mortgage loans are priced to recover the institution's operating expenses, funding costs, and risk premium. If an undercapitalized institution cannot demonstrate a reasonable expectation of avoiding losses, regional directors (or designees) should exercise their authority to halt such practices.

Example of Pricing of ARMs

One method to determine if thrifts are appropriately pricing ARMs is to compare the expected returns on originated ARMs with yields on comparable ARMs in the secondary market.

Specifically, a comparison can be made with secondary market data to determine whether the points received by the institution for originating the ARM compensate the institution for the discount that would be demanded by the secondary market to accept the risks of that ARM. If the discount required by the secondary market is larger than the fee received by the institution for originating the ARM, that may suggest the institution is not pricing its ARMs to avoid losses.

For example, if market conditions are such that an ARM pass-through certificate (PC) with a given margin (the fixed spread between an index value and the interest rate) and initial loan rate with a market price of 97 1/2, ARMs in the mortgage pool backing such a PC would need to impose an origination fee of at least 2 1/2 points to break even. Thus, if an ARM with similar characteristics as the ARMs in the PC were quoted by an originating institution with less than 2 1/2 points being charged to a borrower, it would appear to be inadequately priced. The originator could not recoup its costs by selling the ARM loan in the secondary market.

Documentation

Regulatory requirements state what types of records must be maintained for each loan made or purchased. The underlying philosophy concerning the documentation requirements does not stop with just being able to prove that each loan is properly documented. Each of the required documents serves a valuable purpose in the underwriting process and should be evaluated, analyzed, and relied upon by lending personnel. Regulators, during the loan review process, should be able to determine that the documentation has been used by the lending personnel for the purposes for which it was intended. Following is a partial list of documents required by § 563.170 of the regulations with respect to loans secured by real estate:

- Loan Application: signed by the borrower or its agent, that must disclose the purpose of the loan and the identity of any security property;
- Promissory Note: evidencing the borrower's obligation to repay the loan, executed by the borrower or its agent;
- Deed of Trust or Mortgage Instrument: evidencing the creation of a security interest in the described real estate for the benefit of the lender, signed by the borrower or its agent;
- Appraisal Report: prepared at the request of the lender, by an appraiser approved by the board of directors consistent with the lender's appraisal policy; it should disclose the market value of the security offered by the borrower as of a specific date;
- Financial Statement and/or Credit Report: documents traditionally used in underwriting a credit request; they should be current at the time of application and signed by the borrower disclosing its ability to repay the loan or a written credit report. The following guidelines should be used as to what constitutes a "current" financial statement:
  - — For individual borrowers seeking to purchase, refinance, or construct a one- to four-family dwelling, financial statements should reflect the borrower's financial condition as of the day of application.
  - — For individuals or businesses seeking to purchase, refinance, construct, or develop commercial properties, audited financial statements may not exceed 15 months of age. Tax return statements must be for the immediately preceding taxable year.
  - — For individuals or businesses seeking to purchase, refinance, construct, or develop commercial properties, unaudited financial statements should be dated and verified as close to the date of commitment as possible, but in all cases within six months of the commitment date.
  - — Common sense and prudent underwriting should always prevail. Borrowers whose profit and loss fluctuates considerably should be more carefully scrutinized and

financial statements should reflect more recent data than those for borrowers whose business histories reflect a stable income stream.

- Approval: approval sheet or committee minutes showing the entity responsible for approving the request, along with the terms and conditions of the approval;
- Inspection Reports: for construction and development loans, a record that demonstrates that the work for which each disbursement is sought has been completed;
- Title Policy/Opinion of Title: affirming the description, validity, and priority of the lender's lien on the real estate security for the loan; and
- Settlement Statement/Disclosure Statement: evidence proving that the lender provided the borrower, upon closing and application, a loan settlement statement and disclosure statement setting forth in detail the charges or fees payable by the borrower to the lender.

Some institutions may have policies and procedures in effect that allow no-doc or low-doc loans. No-doc loans refer to loans with no borrower financial information or credit history documentation on file. A no-doc loan is clearly a regulatory violation and an unsafe and unsound lending practice because it lacks the performance of a financial and credit analysis. Consequently, a no-doc loan may result in enforcement action being taken by the OTS. Low-doc loans refer to loans with less financial information and credit history documentation on file than is customarily obtained on a borrower. The granting of a low-doc mortgage loan, when done in compliance with regulatory requirements and prudent underwriting standards, is not in and of itself an unsafe and unsound lending practice. An institution that adopts a low-doc mortgage lending policy must exercise even greater care and underwriting judgment than usual in order to rely on borrower-provided certifications and documentation.

Because of their higher level of delinquencies and defaults, low-documentation loans should receive increased scrutiny. Data gathered on certain low-documentation loan programs indicate that the underwriting for some of the loans was imprudent, and there is evidence of material overstatement of borrower income and an understatement of obligations.

Regulators should be aware of the secondary market limitations associated with low-documentation loans. Both the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) limit the purchase of loans that have less than industry-standard documentation. The purchase of such loans has been limited to a negotiated basis, and usually with credit enhancements required.

Special Rule For Small-Business and Farm Loans

On March 30, 1993, the agencies issued a joint policy statement regarding documentation of small- and medium-sized business and farm loans. Under that policy statement, well managed (those with CAMEL ratings of 1 or 2), well- or adequately capitalized institutions are allowed to establish a "basket" of small- and medium-sized business and farm loans that will not be subject to examiner criticism based on documentation. (On September 8, 1993, OTS issued Thrift Bulletin (TB) 61, which allowed certain 3-rated institutions to apply to use this authority.) The total amount of an institution's loans under this program, however, could not exceed 20% of its total capital, and individual loans are limited to $900,000. Also, institutions are still expected to comply with OTS loans to one borrower and appraisal regulations, as applicable. Under the proposed safety and soundness regulations (discussed below), the interagency policy statement would continue to apply.

In an effort to make the loan documentation requirements for banks and thrifts consistent, the OTS amended its loan documentation regulation of 12 CFR 563.170(c)(1) through (7) to conform to the interagency policy statement for documentation of small- and medium-sized business and farm loans.

Proposed Interagency Credit Underwriting and Loan Documentation Standards

Section 39(a) of the Federal Deposit Insurance Corporation Improvement Act of 1991 requires the federal bank regulatory agencies to prescribe standards relating to credit underwriting and loan documentation. In the proposed regulation issued on November 18, 1993, the agencies established the general parameters of safe and sound credit underwriting practices. The proposed standards would require each institution to establish and maintain prudent credit underwriting practices that:

- are commensurate with the types of loans the institution will make and consider the terms and conditions which they will be made;
- consider the nature of the markets in which loans will be made;
- consider, prior to credit commitment, the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed;
- establish a system of independent, ongoing credit review with appropriate communication to management and to the board of directors;
- take adequate account of concentration of credit risk; and
- are appropriate to the size of the institution and the nature and scope of its activities.

The proposed regulation also would require institutions to maintain sufficient loan documentation to:

- enable the institution to make an informed lending decision and to assess risk as necessary on an ongoing basis;
- identify the purpose of the loan and the source of repayment and assess the ability of the borrower to repay the indebtedness;
- ensure that any claim against a borrower is legally enforceable;
- demonstrate appropriate administration and monitoring of a loan; and
- take account of the size and complexity of a loan.

The proposed regulation provides a standard against which compliance can be measured, while at the same time allowing for differing approaches to credit underwriting and loan documentation. When the agencies issue the final rule, OTS will review the need for the current regulatory documentation requirements of 12 CFR 563.170.

Loan Participations

Purchased whole or participation interests in real estate loans require much of the same documentation as loans originated by an institution. Section 563.170(c)(1) sets forth the documentation required of loans secured by real estate. Section 563.170(c)(3) sets forth the documentation required of loan purchases or participations.

Lead Lender's Responsibility ¾ It is important for institutions to remain aware of their duties, both contractual and fiduciary, in participation lending. The lead lender (the seller or institution responsible for initiating the participation agreement with other institutions) is responsible for obtaining all documentation required by § 563.170(c)(1). The lead lender should provide copies of this information, as required by § 563.170(c)(3), and its underwriting standards to each participating institution. Institutions and their legal counsels should ensure that regulatory requirements are adhered to for new as well as existing participation loans.

Purchasing Association's Responsibility ¾ Associations that purchase participation loans must obtain adequate documentation from the lead lender and properly analyze the purchased loan for credit quality. Purchasers should subject participation loans to the same critical review and documentation requirements as those originated by the purchasing association. In addition, the purchasing association should continually monitor the participation loan to ensure the lead lender is fulfilling its duties and responsibilities. At a minimum, purchasers should be alert to any modification of the loan terms or changes in credit quality.

The recordkeeping requirements for participation interests in a mortgage pool are outlined in Statement of Policy § 571.13.

Mortgage Blanket Hazard Insurance

Section 571.4 requires savings associations to include in its loan contracts provisions that require the maintenance of such hazard insurance as will protect the savings association from loss in the event of damage to or destruction of the real estate securing the savings association's loans.

A number of insurance companies have devised mortgage blanket hazard insurance policies for use by mortgage lenders, thereby eliminating the need to hold and supervise separate policies for each borrower. To be acceptable from a legal and supervisory standpoint, the following minimums should be covered:

- The policy should insure the association against hazards customarily insured against by mortgage lenders in the area in which the association operates and in an amount determined to be adequate by the board of directors.
- The policy should clearly state the specific actions, practices, and procedures to be performed by the association as a condition of the issuance and continuance of the policy in order to realize any claim thereunder.
- The policy should clearly and fully state the manner by which the insured qualifies for settlement of any insured loss, including the conditions for the manner of settlement.
- The policy should provide that the insurer give the savings association at least 60 days advance notice of cancellation or notice of refusal to renew.
- The policy should clearly state, and include as part of the contract between the parties, that the insured association will, as a condition of this insurance, perform the following five (5) acts:
  - — require borrowers to maintain fire and extended-coverage insurance in the amount of the lesser of the loan balance or the replacement value, with the association named as the mortgagee;
  - — affirm at closing the actual existence of valid insurance as required;
  - — not inform or imply to any person that hazard insurance is unnecessary or is not to be maintained;
  - — upon learning that hazard insurance will terminate, procure fire and extended-coverage insurance as necessary and pay the premiums to prevent the lapse of adequate protection of the property; and
  - — cooperate with the insurers in distributing, at least annually, reminder memorandums to the borrower that hazard insurance shall be maintained.

A blanket hazard insurance policy meeting the minimum standards, as set forth above, will (1) provide an acceptable measure of protection for the interests of the savings association and its borrowing members and (2) evidence compliance with the requirements of § 571.4.

Late Charges

Section 545.34 allows a savings association to include in its loan contract a provision that allows for the imposition of late charges because of any delinquent periodic payment. A savings association does not, however, have the authority to impose or collect late charges unless (1) the borrower has signed an agreement that obligates him or her to pay late charges imposed as a result of late payment of a mortgage or (2) an appropriate state statute authorizes the late charge. The prohibition on collection of late charges without appropriate authorization applies to loans originated or purchased by the savings association.

Section 545.34 further prohibits the deduction of late charges from the regular periodic installment payment on a mortgage loan. This prohibition remains in effect even though the association may be preparing the loan to be sold and the purchaser's agreements state to the contrary.

Note: The Office of the Chief Counsel has opined that savings associations are not prohibited from refusing to accept a loan payment because of unpaid late charges.

REFERENCES

United States Code (12 USC)

§ 1464	Home Owners' Loan Act: Loans or
(5)(c)(1)	Investments Without Percentage of Assets Limitations
§ 1464(5)(c)(2)	Home Owners' Loan Act: Loans or Investments Limited to a Percentage of Assets or Capital
§ 1464(5)(c)(3)	Loans or Investments Limited to 5 Per Cent of Assets

Code of Federal Regulations (12 CFR)

Subchapter C: Regulations for Federal Savings Associations

§ 545.32	Real Estate Loans
§ 545.33	Home Loans
§ 545.34	Limitations for Home Loans Secured by Borrower Occupied Property
§ 545.35	Other Real Estate Loans
§ 545.36	Loans to Acquire or to Improve Real Estate
§ 545.38	Insured and Guaranteed Loans
§ 545.39	Loans Guaranteed Under the Foreign Assistance Act of 1961
§ 545.40	Loans on Low Rent Housing
§ 545.41	Community Development Loans and Investments
§ 545.44	Mortgage Transactions with FHLMC
§ 556.11	Prepayment Penalty on Mortgage Loans
§ 556.17	Effect of Loan Participations on Status of Borrowing Members

Subchapter D: Regulations Applicable to All Savings Associations

§ 563.41	Loans and Other Transactions with Affiliates and Subsidiaries
§ 563.43	Restrictions on Loans, Other Investments, and Real Personal Property Transactions Involving Affiliated Persons
§ 563.44	Loans Involving Mortgage Insurance
§ 563.48	Flood Disaster Protection
§ 563.93	Loans-to-One Borrower
§ 563.97	Loans in Excess of 90 Percent of Value
§ 563.100-101	Real Estate Lending Standards
§ 563.170	Examinations and Audits; Appraisals; Establishment and Maintenance of Records
§ 563.172	Reevaluation of Real Estate Owned
§ 563.173	Forward Commitments
§ 564	Appraisals
§ 571.4	Hazard Insurance
§ 571.13	Participation Interests in Pools of Loans

Subchapter G: Regulations for Federally Related Mortgage Loans

§ 590.3	Operation

Office of Thrift Supervision Bulletins

RB 3a-1	Policy Statement on Growth for Savings Associations
RB 15	Covered Asset Sales
TB 16	Environmental Risk and Liability
TB 26	Substitute Mortgage Insurance for Ticor Mortgage Insurance Corporation (TMIC) Loans
TB 31-3	Securities Disclosure Obligation Arising as a Result of Regulatory Bulletin 3a
TB 31-8	New Transactions with Affiliates and Insider Lender Rules for Thrifts
TB 36-1	Guidelines on Interest, Prepayment, and Loan Origination Rates
TB 37a	Use of Appraisal Information in Loan Risk Analysis
TB 61	Interagency Policy Statement on Documentation for Loans to

	Small- and Medium-Sized Businesses and Farms

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Specifies GAAP Accounting for Losses and Contingencies
No. 91	Specifies GAAP Accounting for Loan Fees
No. 114	Accounting by Creditors for Impairment of a Loan

Other References

11/7/91	Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans
3/30/93	Documentation for Loans to Small- and Medium-Sized Businesses and Farms

Federal National Mortgage Association Underwriting Guidelines

Thrift Activities Handbook Section 410, Financial Records and Reports